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Social Security Reform

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CONTENTS

Social Security Reform

SUMMARY

On February 2, 2005, President Bush highlighted Social Security reform during the State of the Union address as a top priority during his second term. The President did not present a detailed plan for reform. Rather, he put forth guidelines for Congress to consider in the development of legislation to create personal accounts within a program in need of "wise and effective reform." The President also acknowledged that other changes would be needed to address the system's projected long-range funding shortfall. In recent years, reform ideas have ranged from relatively minor changes to the current pay-as-you-go social insurance system to a redesigned program based on personal savings and investments modeled after IRAs and 401(k)s.

Currently, the Social Security system is generating surplus revenues. However, its board of trustees reports that, under its intermediate (or mid-range) projections, the trust funds would be depleted in 2041. At that point, an estimated 74% of benefits would be payable with incoming receipts. On average, over the next 75 years, the trustees project that the system's costs would be 14% higher than its income. By 2080, projected costs would be 43% higher than income. The primary reason is demographic: the post-World War II baby boomers will begin retiring in 2008 and life expectancy is projected to increase. Between 2005 and 2025, the number of people age 65 and older is projected to grow by 69%. In contrast, the number of workers supporting the system is projected to grow by 13%.

The trustees project that surplus Social Security revenues plus interest will cause the trust funds, comprised of federal bonds, to peak at $6.0 trillion in 2026. Thereafter, the system's outgo is projected to exceed income, and the trust funds would be drawn down until depletion in 2041. However, the trustees project that the system's tax revenue would fall below outgo beginning in 2017. At that point, other federal receipts would be needed to help meet benefit costs (by providing cash as the federal bonds held by the trust funds are redeemed). If there are no other surplus governmental receipts, policymakers would have three options: raise taxes or other income, reduce spending, or borrow the money.

Public opinion polls that show fewer than 50% of respondents are confident that Social Security can meet its long-term commitments. In addition, there is growing public perception that Social Security may not be as good a value for future retirees. These concerns and a belief that the nation must increase its national savings (partly in response to the projected increase in the number of people age 65 and older) have led to proposals to redesign the system.

Others suggest that the system's financial outlook is not a "crisis" in need of immediate action. Supporters of the current program structure point out that the system is now running surpluses, continues to have public support and could be adversely affected by the risk associated with some of the new reform ideas. They contend that only modest changes are needed to restore long-range solvency to the system.

In the 109th Congress, Representatives Kolbe, Sam Johnson and Shaw and Senator Hagel have introduced reform proposals that would establish a system of personal accounts to supplement or replace part of the Social Security system (H.R. 440, H.R. 530, H.R. 750 and S. 540, respectively).

MOST RECENT DEVELOPMENTS

On February 2, 2005, President Bush highlighted Social Security reform during his State of the Union address as a top priority of his second term in office. The President did not present a detailed plan for reform. Rather, he used the opportunity to put forth guidelines for Congress to consider in the development of legislation to create personal accounts within a program in need of "wise and effective reform."

The President offered the following guidelines for reform: (1) workers born before 1950 (i.e., workers age 55 and older in 2005) would not be affected by personal accounts or other components of reform; (2) participation in personal accounts would be voluntary; (3) eligible workers would be allowed to redirect up to 4% of covered earnings into a personal account, initially up to $1,000 per year; (4) a centralized government entity would administer the accounts; and (5) workers would be required to annuitize the portion of the account balance needed to provide at least a poverty-level stream of life-long income, with any remaining balance available as a lump sum. While President Bush has supported a "carve-out" funding approach for personal accounts (i.e., a redirection of current payroll taxes), Treasury Secretary Snow indicated on March 2, 2005, that the Bush Administration may be willing to consider an alternative "add-on" funding approach.

In addition to stating his support for personal accounts as part of the creation of an "ownership society," the President acknowledged that other changes would be needed to address the system's projected long-range funding shortfall. The President cited several potential program changes that would be on the table for consideration: (1) raising the full retirement age; (2) reducing benefits for wealthy recipients; and (3) modifying the benefit formula. The only approach ruled out by President Bush was an increase in payroll taxes. However, the President did not specify whether this was in reference to payroll tax rates, increases in the amount of earnings subject to the payroll tax, or both.

In the 109^{th} Congress, Representatives Kolbe, Sam Johnson and Shaw and Senator Hagel have introduced reform proposals that would establish a system of personal accounts to supplement or replace part of the Social Security system (H.R. 440, H.R. 530, H.R. 750 and S. 540, respectively).

BACKGROUND AND ANALYSIS

President Bush's initiative to restructure Social Security through the creation of personal accounts has moved the policy issue to the forefront of the political debate. The President advocates a system in which benefits would be based increasingly on what is referred to as a pre-funded system through personal savings and investments with the creation of personal accounts. He has pointed to the system's projected long-range deficit as a driver for change in conjunction with his vision of an "ownership society." Most Democrats support maintaining the current structure of the program (a system of defined benefits funded on a pay-as-you-go basis). Democrats have pointed to the system's long-range financial projections to support their view that the system is not in "crisis," and that only modest changes aimed at supporting the current structure may be needed.

Currently, Social Security income exceeds outgo. The Social Security Board of Trustees (comprised of three officers of the President's Cabinet, the Commissioner of Social Security, and two public representatives) projects that, on average over the next 75 years, Social Security outgo will exceed income by 14% and by 2041 the trust funds would be depleted (based on the intermediate, or mid-range, projections). At that point, revenues would pay for an estimated 74% of program costs. One of the main reasons is demographic: the leading edge of the post-World War II baby boom generation will begin retiring in 2008 and projected increases in life expectancy will contribute to an older society. Between 2005 and 2025, the number of people age 65 and older is predicted to increase by 69%, while the number of workers whose taxes will finance future benefits is projected to increase by only 13%. As a result, the number of workers supporting each recipient is projected to decline from 3.3 today to 2.3 in 2025.

Social Security revenues are paid into the U.S. Treasury and most of the proceeds are used to pay for benefits. Surplus revenue is invested in federal securities recorded to the Old Age, Survivors, and Disability Insurance (OASDI, the formal name for Social Security) trust funds maintained by the Treasury Department. Social Security benefits and administrative costs are paid out of the Treasury and a corresponding amount of trust fund securities are redeemed. Whenever current Social Security taxes are insufficient to pay benefits, the trust fund's securities are redeemed and Treasury makes up the difference with other receipts.

Currently, Social Security tax revenues exceed what is needed to pay benefits. These surpluses and interest credited to the trust funds in the form of government bonds appear as growing trust fund balances. The trustees project that the trust fund balances will peak at $6.0 trillion in 2026, after which the system's outgo would exceed income and the trust fund balances would begin to decline. By 2041, the trust funds would be exhausted and technically insolvent. By 2017, Social Security tax revenue (i.e., excluding interest credited to the trust funds) would fall below the system's outgo. Because interest credited to the trust funds is an exchange of credits between Treasury accounts — and not a resource for the government — other federal receipts would be needed to meet the system's costs starting in 2017 (in other words, the government would begin redeeming bonds held by the trust funds). At that point, policymakers would have three options: raise taxes, reduce spending, or borrow the money from the public (i.e., replace bonds held by the trust funds with bonds held by the public). The system's reliance on general revenues is projected to be $64 billion by 2020 and $256 billion by 2030 (in constant 2005 dollars).

Today, the annual cost of the system ($527 billion) is equal to 11.13% of workers' pay subject to Social Security taxation (or taxable payroll). It is projected to increase slowly over the next several years, reaching 11.93% of payroll in 2013. It would then rise more precipitously to 15.55% in 2025 and 17.37% in 2035, as the baby boomers retire. Afterward, the system's cost would rise slowly to 19.12% of payroll in 2080. Over the entire period (2005-2079), the system's average cost would be 15.79% of payroll, or 14% higher than its average income. However, the gap between income and outgo would grow throughout the period and by 2080 income would equal 13.38% of taxable payroll, outgo would equal 19.12% of taxable payroll, and the gap would equal 5.75% of taxable payroll. By 2080, outgo would exceed income by 43%.

This projected long-range financial outlook is mirrored in public opinion polls that show fewer than 50% of respondents express confidence in Social Security's ability to meet its

long-term commitments. There is a growing public perception that Social Security may not be as good a value in the future. Until recent years, retirees could expect to receive more in benefits than they paid in Social Security taxes. However, because Social Security tax rates have increased to cover the costs of a maturing “pay-as you-go” system, these ratios have become less favorable. Such concerns and a belief that the nation must increase national savings to meet the needs of an increasingly elderly society have led to proposals to reform the system.

Supporters of the current program structure suggest that the issues confronting the system are not as serious as sometimes portrayed and believe there is no imminent crisis. They point out that the system is now running surpluses, that there continues to be public support for the program, and there would be considerable risk in some of the new reform ideas. They contend that relatively modest changes could restore long-range solvency to the system.

Basic Debate

The Social Security system has faced funding shortfalls in the past. In 1977 and 1983, Congress enacted a variety of measures to address the system’s financial imbalance. These measures include constraints on the growth of initial benefit levels, a gradual increase in the full retirement age from 65 to 67 (i.e., the age at which unreduced benefits are payable), payroll tax increases, taxation of benefits for higher-income recipients, and extension of Social Security coverage to federal and nonprofit workers. Subsequently, projections showed the re-emergence of long-term deficits as a result of changes in actuarial methods and assumptions, and because program changes had been evaluated with respect to their effect on the *average* 75-year deficit. That is, while program changes were projected to restore trust fund solvency on average over the 75-year period, a period of surpluses was followed by a period of deficits.

Some policymakers believe that some type of action should be taken sooner rather than later. This view has been shared by the Social Security trustees and other recent panels and commissions that have examined the problem. In recent years, a wide range of interest groups have echoed this view in testimony before Congress. However, there is no consensus on whether the projections represent a “crisis.” In 1977 and 1983, the trust fund balances were projected to fall to zero within a very short period (within months of the 1983 reforms). Today, the problem is perceived to be as few as 12 or as many as 36 years away. Lacking a “crisis,” the pressure to compromise is diffused and the issues and the divergent views about them have led to myriad complex proposals. In 1977 and 1983, the debate was not about fundamental reform. Rather, it revolved around how to raise the system’s income and constrain costs. Today, the ideas range from restoring the system’s solvency with as few alterations as possible to replacing it entirely with something modeled after IRAs or 401(k)s. This broad spectrum was clearly reflected in the 1997 Social Security Advisory Council report, which presented three different reform plans. None of the three plans was supported by a majority of the council’s 13 members. Similar diversity is reflected in the Social Security reform bills introduced in recent Congresses.

Push for Major Reform. Advocates of reform view Social Security as an anachronism, built on depression-era concerns about high unemployment and widespread

"dependency" among the aged. They see the prospect of reform today as an opportunity to modernize the way society saves for retirement. They maintain that the vast economic, social and demographic changes that have transpired over the past 68 years require the system to change, and they point to changes made in other countries that now use market-based personal accounts to strengthen retirement incomes and bolster their economies by spurring savings and investments. They believe government-run, pay-as-you-go systems are unsustainable in aging societies. They prefer a system that allows workers to acquire wealth and provide for their retirement by investing in personal accounts.

They also view it as a way to counter skepticism about the current system by giving workers a greater sense of ownership of their retirement savings. They contend that private investments would yield larger retirement incomes because stocks and bonds have provided higher returns than are projected from the current system. Some believe that personal accounts would address what they view as the system's contradictory mix of insurance and social welfare goals (although benefits are not based strictly on a worker's contributions, many of its social benefits go to financially well-off individuals in the absence of a means test). Others maintain that creating a system of personal accounts would prevent the government from using surplus Social Security taxes for other government spending.

Others, who do not necessarily seek a new system, view enactment of long-range Social Security constraints as one way to curb federal entitlement spending. The aging of society means that the cost of entitlement programs that aid the elderly will increase greatly in the future. The costs of the largest entitlement programs, Social Security, Medicare, and Medicaid, are directly linked to an aging population. Proponents of imposing constraints on these programs express concern that, if left unchecked, their costs would place a large strain on the federal treasury far into the future, consuming resources that could be used for other priorities and forcing future generations to bear a much higher tax burden.

As a matter of fairness, it has been pointed out that many of today's recipients get back more than the value of their Social Security contributions, and far more than the baby boom generation will receive. They believe that to delay making changes to the program is unfair to today's workers, who must pay for "transfer" payments that they characterize as "overgenerous" and unrelated to need, while facing the prospect that their own benefits may have to be scaled back severely. Others emphasize the system's projected long-range funding shortfall and contend that steps should be taken soon (e.g., raising the full retirement age, constraining future growth in initial monthly benefits, reducing COLAs, raising taxes) so that changes can be phased in, allowing workers more time to adjust their retirement expectations/plans to reflect what these programs will be able to provide in the future. Otherwise, they maintain that more abrupt changes in taxes and benefits would be required.

Arguments for Retaining the Existing System. Those who favor a more restrained approach believe that the issues facing the system can be resolved with modest tax and spending changes, and that the program's critics are raising the specter that Social Security will "bankrupt the Nation" in order to undermine public support and to provide an excuse to "privatize" it. They contend that personal savings accounts would erode the social insurance nature of the current system that favors low-income workers, survivors and the disabled.

Others are concerned that switching to a new system of personal accounts would pose large transitional problems by requiring today's younger workers to save for their own retirement while paying taxes to cover benefits for current retirees. Some doubt that it would increase national savings, arguing that higher government debt (resulting from the redirection of current payroll taxes to personal accounts) would offset the increased personal account savings. They also contend that the capital markets' inflow created by the accounts would make the markets difficult to regulate and potentially distort equity valuations. They point out that some of the countries that have moved to personal accounts did so to create capital markets. Such markets, they argue, are already well developed in the United States.

Some believe that a system of personal accounts would expose participants to excessive market risk for an income source that has become so essential to many of the nation's elderly. They say that the nation now has a three-tiered retirement system — Social Security, private pensions and personal assets — that already has private saving and investment components. They contend that while people may want and be able to undertake some "risk" in the latter two tiers, Social Security — as the tier that provides a basic floor of protection — should be more stable. They further contend that the administrative costs of maintaining personal accounts could be very large and significantly erode their value.

Some say that concerns about future growth in entitlement spending are overblown, arguing that as people live longer, they will work longer as labor markets tighten and employers offer inducements for them to remain on the job. They state that a projected low ratio of workers to dependents is not unprecedented, as it existed when the baby boomers were in their youth.

Specific Areas of Contention

System's Financial Outlook. There are conflicting views about the severity of Social Security's projected funding shortfall. Some maintain that the problem is more acute than has been portrayed traditionally (e.g., as having an average 75-year deficit of 14%, or 1.92% of taxable payroll). They believe this view is supported by a new portrayal in the trustees report showing that, if projections are extended beyond the 75-year window, the status of the program is even more dire (i.e., the projected long-range deficit over the "infinite horizon" would be 3.5% of taxable payroll). They also point out that the system's costs are projected to exceed receipts by 3.54% of taxable payroll in 2030 (a difference of 27% between the system's projected income — 13.20% of taxable payroll — and the system's projected cost — 16.74% of taxable payroll). In 2080, the gap would be 5.75% of taxable payroll (a difference of 43% between the system's projected income — 13.38% of taxable payroll — and the system's projected cost — 19.12% of taxable payroll). Thus, on a pay-as-you-go basis, the system would need much more than a 14% change in taxes or expenditures over the next 75 years to cover projected program costs. They maintain that viewing the problem as 36 years away (because the trust funds would have a balance until 2041) does not take into account the financial pressure Social Security will exert on the government beginning in 2017 when projected expenditures would exceed tax revenue. At that point, the government would have to rely on other resources to help cover program costs, resources that could be used to finance other governmental functions.

Others express concern that the problem is being exaggerated. First, they maintain that in contrast to earlier episodes of financial imbalance, the system has no immediate problem. Surplus tax receipts are projected for 12 years and the trust funds are projected to have a balance for 36 years. They state that projections for the next 75 years, let alone the indefinite future, cannot be viewed with any significant degree of confidence and Congress should respond to them cautiously. They maintain that even if the 75-year projections hold, the average imbalance could be eliminated by increasing the payroll tax rate immediately by 0.96 percentage point on both employees and employers. They point out that as a share of GDP, projections show that the system's cost would increase from 4.26% today to 6.14% in 2030. While acknowledging that this would be a notably larger share of GDP, they point out that GDP itself would have risen substantially in real terms. Moreover, while the ratio of workers to recipients is projected to decline, they believe that employers are likely to respond with inducements for older workers to stay on the job longer. Phased-in retirements are becoming more prevalent, and older workers are increasingly viewing retirement as something other than an all-or-nothing decision.

Congressional Budget Office (CBO) projections released in March 2005 (*Updated Long-Term Projections for Social Security*) provide a somewhat more favorable long-range outlook for the Social Security system. CBO projects that the system will begin running cash flow deficits in 2020 (3 years later than the trustees' projections), and that the trust funds will remain solvent until 2052 (11 years later than the trustees' projections). At that point, annual revenues would be sufficient to cover an estimated 78% of promised benefits. In its June 2004 report (*The Outlook for Social Security*), CBO noted that, despite the differences between their projections and those of the trustees, the basic conclusion is the same — "under current law, the program will generate a sustained and significant demand for budgetary resources" [*page 29*]. CBO's March 2005 report may be accessed at [http://www.cbo.gov/ftpdocs/60xx/doc6064/03-03-LongTermProjections.pdf]; CBO's June 2004 report may be accessed at [http://www.cbo.gov/showdoc.cfm?index=5530&sequence=0&from=7].

Public Confidence. Recent polls have shown that a majority of Americans lack confidence in the system's ability to meet its future commitments. While skepticism abated following enactment of legislation in 1983 to shore up the system, it has risen again with just over half of the public now expressing a lack of confidence [*CBS News/New York Times Poll*, November 2004]. Younger workers are particularly skeptical. For example, 62% of persons ages 18-34, 56% of persons ages 35-44, and 49% of persons ages 45-54 expressed a lack of confidence in the system's ability to pay promised benefits in the future, compared to 16% of persons age 55 and older [*Newsweek Poll*, February 2005].

Some observers express caution about inferring too much from polling data, arguing that public understanding of Social Security is limited and often inaccurate. They maintain that a major reason confidence is highest among older persons is that, being more immediately affected, they have learned more about the program. In 1995, the Social Security Administration began phasing in a system to provide annual statements to workers, which some believe will make workers more aware of their promised benefits and thus more trusting of the system. Others, however, suggest that skepticism is justified by the system's repeated financial difficulties and diminished "money's worth" for younger workers.

Doubts About Money's Worth. Until recent years, Social Security recipients received more, often far more, than the value of the Social Security taxes they paid. However, because Social Security tax rates have increased over the years and the full retirement age (the age at which unreduced benefits are first payable) is being increased gradually, it is becoming more apparent that Social Security will be less of a good deal for many future retirees. For example, for workers who earned average wages and retired in 1980 at age 65, it took 2.8 years to recover the value of the retirement portion of the combined employee and employer shares of their Social Security taxes plus interest. For their counterparts who retired at age 65 in 2003, it will take 17.4 years. For those retiring in 2020, it will take 21.6 years (based on the trustees' 2003 intermediate forecast). Some observers believe these discrepancies are inequitable and cite them as evidence that the system needs to be substantially restructured.

Others discount this phenomenon, viewing Social Security as a *social insurance* program serving social ends that transcend questions of whether some individuals do better than others. For example, the program's anti-poverty features replace a higher proportion of earnings for low-paid workers and provide additional benefits for workers with families. Also, today's workers who will receive less direct value from their taxes than today's retirees, have in large part been relieved from having to support their parents, and many elderly are able to live independently and with dignity. These observers contend that the value of these aspects of the system is not reflected in simple comparisons of taxes and benefits.

"Privatization" Debate. Social Security's projected long-range financing problems, skepticism about the sustainability of the current system, and a belief that economic growth could be bolstered through increased savings have led to a number of proposals to "privatize" part or all of the system, reviving a philosophical debate that dates back to its creation in 1935. All three plans presented by the 1994-1996 Social Security Advisory Council featured program involvement in the financial markets. The first called upon Congress to consider authorizing investment of part of the Social Security trust funds in equities (on the assumption that stocks would produce a higher return to the system). The second would require workers to contribute an extra 1.6% of pay to personal accounts to make up for Social Security benefit reductions called for under the plan to restore the system's long-range solvency. The third would redesign the system by gradually replacing Social Security retirement benefits with flat-rate benefits based on length of service and personal accounts (funded with 5 percentage points of the current Social Security tax rate).

The reform that Chile enacted in 1981, which replaced a troubled pay-as-you-go system with one requiring workers to invest part of their earnings in personal accounts through government-approved pension funds, has been reflected in a number of reform bills introduced in recent Congresses. These measures would permit or require workers to invest some or all of their Social Security tax into personal accounts. Most call for future Social Security benefits to be reduced or forfeited. Similarly, the three options presented by the commission appointed by President Bush in 2001 would allow workers to participate in personal accounts and would reduce their eventual Social Security benefit by the projected value of the account based on a specified (rather than the actual) rate of return.

Another approach is reflected in bills that would require any budget surpluses to be used to finance personal accounts to supplement Social Security benefits for those who pay Social

Security taxes. President Clinton's January 1999 reform plan would have allocated a portion of budget surpluses to personal accounts, supplemented by a worker's own contributions and a government match (scaled to income). The plan also called for the redirection of a portion of budget surpluses, or the interest savings resulting therefrom, to the Social Security trust funds. Some of the funds would be used to acquire stocks, similar to the approach suggested in one of the Advisory Council plans and in some recent bills. Most of these approaches would require establishment of an independent board to invest some of the funds in stocks or corporate bonds and the remaining funds in federal securities.

Some personal account proponents believe that personal accounts would reduce future financial demands on government and reassure workers by giving them a sense of ownership of their retirement savings. Others believe that personal accounts would enhance workers' retirement income because stocks and bonds generally have provided higher rates of return than are projected from Social Security. In concert with this, they maintain that personal accounts would increase national savings and promote economic growth. Others maintain that personal accounts would prevent the government from using surplus Social Security revenues to "mask" public borrowing, or for other spending or tax reductions. Generally, proponents of personal accounts express concern that investing the Social Security trust funds in the markets would concentrate too much economic power in a government-appointed board.

Opponents of personal accounts maintain that Social Security's long-range financing problems could be resolved without altering the program's fundamental nature. They express concern that replacing Social Security with personal accounts would erode the social insurance aspects of the system that favor low-wage earners, survivors and the disabled. Others are concerned that personal accounts would pose large transition problems by requiring today's younger workers to save for their own retirement while simultaneously paying taxes to support current retirees, and would further exacerbate current budget deficits. Some doubt that personal accounts would increase national savings, maintaining that any increase in private savings would be offset by increased government borrowing. They also point out that the investment pool created by the accounts could be difficult to regulate and distort capital markets and equity valuations. Still others view it as exposing participants to excessive market risk for something as essential as core retirement benefits and, unlike Social Security, as providing poor protection against inflation. Many prefer "collective" investment of the Social Security trust funds in the markets to potentially bolster their returns and spread the risks of poor performance broadly.

Retirement Age Issue. Raising the Social Security retirement age is often considered as a way to help restore long-range solvency to the system. Much of the growth in Social Security's costs is a result of increasing life expectancy. Since benefits were first paid in 1940, life expectancy for 65-year-old men and women has risen from 12.7 and 14.7 years, respectively, to 17.0 and 19.7 years, respectively. By 2030, it is projected to be 18.5 and 21.2 years, respectively. This trend bolstered arguments for increasing the full retirement age as a way to achieve savings when the system was facing major financial problems in the early 1980s. Congress raised the "full benefit" age from 65 to 67 as part of the Social Security Amendments of 1983 (P.L. 98-21). This change is being phased in starting with those born in 1938, with the full two-year hike affecting those born after 1959. The 1983 amendments did not raise the early retirement age (age 62), but the benefit reduction for persons who retire at age 62 will increase from 20% to 30%. Proponents of raising the early

and/or full retirement age view it as reasonable in light of projected increases in life expectancy. Opponents believe it will penalize workers who already get a worse deal from Social Security than do current retirees, those who work in arduous occupations, and racial minorities and others who have shorter life expectancies.

Cost-of-Living Adjustments (COLAs). Social Security benefits are adjusted annually to reflect inflation as measured by the Bureau of Labor Statistics' (BLS) Consumer Price Index (CPI), which measures price increases for selected goods and services. The CPI has been criticized for overstating the effects of inflation, primarily because the index's market basket of goods and services was not revised regularly to reflect changes in consumer buying habits or improvements in quality. A BLS analysis in 1993 found that the annual overstatement might be as much as 0.6 percentage points. CBO estimated in 1994 that the overstatement ranged from 0.2 to 0.8 percentage points. A 1996 panel that studied the issue for the Senate Finance Committee argued that it might be 1.1 percentage points.

In response to its own analysis as well as the outside criticisms, the BLS has since made various revisions to the CPI. To some extent, these revisions may account for part of the slower CPI growth seen in recent years. However, calls for adjustments continue. According to the Social Security Administration, a COLA reduction of 0.5 percentage point annually would improve the system's long-range actuarial balance by an estimated 42%. A COLA reduction of 1 percentage point annually would improve the long-range actuarial balance by an estimated 80% (based on the trustees' 2004 intermediate projections). While some view further CPI changes as necessary to help keep Social Security and other entitlement spending under control, others view such changes as a backdoor way of reducing benefits. They maintain that the market basket of goods and services purchased by the elderly is different from that of the general population around whom the CPI is constructed. It is more heavily weighted with healthcare expenditures, which rise notably faster than the overall CPI, and thus they contend that the cost of living for the elderly is higher than reflected by the CPI.

Social Security and the Budget. By law, Social Security is considered to be "off budget" for many aspects of developing and enforcing annual budget goals. However, it is still a federal program and its income and outgo help shape the year-to-year financial condition of the government. As a result, policymakers often focus on "unified" or overall budget totals that include Social Security. When President Clinton urged that then-projected unified budget surpluses be reserved until Social Security's long-range financing problems were resolved, and proposed using a portion of those surpluses to shore up the system, Social Security's budget treatment became a major issue. Congressional views about what to do with the surpluses were diverse, ranging from "buying down" publicly-held federal debt to cutting taxes to increasing spending. However, support for setting aside a portion equal to the annual Social Security trust fund surpluses was substantial. While projected budget deficits have re-emerged, there remains some congressional interest in the concept of a Social Security "lock box."

Initiatives for Change

The 1994-1996 Social Security Advisory Council presented three different approaches to restore long-range solvency to the system, none of which was endorsed by a majority of council members. The first (the "maintain benefits" plan) would maintain the system's

current benefit structure by increasing revenue (including an eventual increase in the payroll tax) and making minor benefit reductions. It was also suggested that a portion of the Social Security trust funds be invested in stocks. The second (the "individual account" plan) addressed the problem mostly with benefit reductions, and in addition would require workers to make an extra 1.6% of pay contribution to new personal accounts. The third (the "personal security account" plan) proposed a major redesign of the system that would gradually replace the current earnings-related retirement benefit with a flat-rate benefit based on length of service and establish personal accounts funded by redirecting 5 percentage points of the current payroll tax. It would cover *transition* costs with an increase in payroll taxes of 1.52% of pay and government borrowing. The conceptual approaches incorporated in the Council's plans are reflected in many of the reform bills introduced in recent Congresses.

In his last three years in office, President Clinton repeatedly called for using Social Security's share of then-projected budget surpluses to reduce publicly-held federal debt and crediting the trust funds for the reduction. In his 1999 State of the Union message, he proposed crediting $2.8 trillion of some $4.9 trillion in budget surpluses projected for the next 15 years to the trust funds — nearly $.6 trillion was to be invested in stocks, the rest in federal securities. The plan was estimated to keep the system solvent until 2059. Concerns were raised that the plan would be crediting the Social Security trust funds twice for its surpluses, and that the plan would lead to government ownership of private companies. Clinton further proposed that $.5 trillion of the budget surpluses be used to create new Universal Savings Accounts (USAs) — 401(k)-like accounts intended to supplement Social Security. In June 1999, he revised his plan by calling for general fund infusions to the trust funds equal to the interest savings achieved by using Social Security's share of the budget surpluses to reduce federal debt. The infusions were to be invested in stocks until the stock portion of the trust funds' holdings reached 15%. In October 1999, he revised the plan again by dropping the stock investment idea — all the infusions were to be invested in federal bonds. His last plan, offered in January 2000, was similar but again called for investing up to 15% of the trust funds in stock.

In May 2001, President Bush appointed a commission to make recommendations to reform Social Security. As principles for reform, the President stated that any plan for reform must preserve the benefits of current retirees and older workers, return Social Security to a firm financial footing, and allow younger workers to invest in personal savings accounts. The commission issued a final report on December 21, 2001, which included three reform options. Each option would allow workers to participate in voluntary personal accounts and reduce their eventual Social Security benefit by the projected value of the account based on a specified (rather than the actual) rate of return. The first option would allow workers to redirect 2% of taxable earnings to these accounts, but would make no other changes. The second option would allow workers to redirect 4% of taxable earnings, up to an annual limit of $1,000; reduce future benefits by indexing their growth to prices rather than wages; and increase benefits to low-paid workers and widow(er)s. The third option would allow workers to contribute an additional 1% of taxable earnings and receive a government match of 2.5% up to an annual limit of $1,000; reduce future benefits by indexing their growth to increases in longevity and, for high-paid workers, by modifying the benefit formula; and increase benefits for low-paid workers and widow(er)s.

On February 2, 2005, President Bush highlighted Social Security reform during his State of the Union address. The President did not present a detailed plan for reform. Rather, he used the opportunity to put forth guidelines for Congress to consider in the development of legislation to create personal accounts within a program in need of "wise and effective reform."

The President offered the following guidelines for reform: (1) workers born before 1950 (i.e., workers age 55 and older in 2005) would not be affected by personal accounts or other components of reform; (2) participation in personal accounts would be voluntary; (3) eligible workers would be allowed to redirect up to 4% of covered earnings into a personal account, initially up to $1,000 per year; (4) a centralized government entity would administer the accounts; and (5) workers would be required to annuitize the portion of the account balance needed to provide at least a poverty-level stream of life-long income, with any remaining balance available as a lump sum. While President Bush has supported a "carve-out" funding approach for personal accounts (i.e., a redirection of current payroll taxes), Treasury Secretary Snow indicated on March 2, 2005, that the Bush Administration may be willing to consider an alternative "add-on" funding approach.

While restating his support for personal accounts as part of the creation of an "ownership society," the President acknowledged that other changes would be needed to address the system's projected long-range funding shortfall. The President cited several potential program changes that would be on the table for consideration: (1) raising the full retirement age; (2) reducing benefits for wealthy recipients; and (3) modifying the benefit formula. The only approach ruled out by the President was an increase in payroll taxes, however, he did not specify whether this was in reference to payroll tax rates, increases in the amount of earnings subject to the payroll tax, or both.

Legislation in the 109th Congress. Representatives Kolbe and Boyd introduced H.R. 440 on February 1, 2005. For workers under age 55, the measure would redirect 3% of the first $10,000 of covered earnings (indexed to average wage growth) and 2% of remaining covered earnings to mandatory personal accounts. Workers would be allowed to make additional contributions of up to $5,000 annually (indexed to inflation), and lower-paid workers would be eligible to receive an additional credit toward their account of up to $600.

With respect to traditional Social Security benefits, the measure would constrain the growth in initial monthly benefits for future retirees by indexing initial benefits to increases in life expectancy (rather than wage growth). In addition, the measure would: accelerate the currently scheduled increase in the full retirement age from 65 to 67; include 40 years of earnings (rather than the highest 35) to compute benefits; reduce cost-of-living adjustments; set widow(er)s' benefits equal to 75% of the couple's combined pre-death benefit (rather than 50%-67%); limit benefits for spouses of higher earners; and provide a minimum benefit tied to the poverty level for workers with at least 40 years of earnings.

With respect to tax changes, the measure would increase the taxable wage base gradually so that 87% of covered earnings are taxable. In addition, it would credit all of the revenue from the taxation of Social Security benefits to the Social Security trust funds (instead of crediting part to Medicare).

The measure would establish a central authority to administer the accounts and provide initial investment options similar to the federal Thrift Savings Plan. Once the account balance reaches $7,500 (indexed to inflation), the worker would be allowed to choose among a broader range of centrally-managed investment options. The personal account would become available at retirement, or earlier if the account balance is sufficient to provide a payment at least equal to 185% of the poverty level. The worker would be required to annuitize the portion of the account balance needed to provide a combined monthly payment (traditional benefit plus annuity) at least equal to 185% of the poverty level. Any remaining balance could be taken as a lump sum.

Representative Sam Johnson introduced H.R. 530 on February 2, 2005. The measure would allow workers ages 21-54 to redirect 6.2 percentage points of the payroll tax to voluntary personal accounts. Participation in personal accounts would be mandatory for persons under age 21. Workers who participate in personal accounts would no longer accrue benefits under the traditional system and would be issued a marketable "recognition bond" equal to the value of benefits already accrued under the current system. The measure would provide workers who participate in personal accounts a minimum benefit equal to a specified percent of the poverty level, ranging from 100% for workers with at least 35 years of earnings to 0% for workers with 10 years of earnings.

Workers who choose not to participate in personal accounts would remain in the current system, however, initial monthly benefits would be lower than those promised under current law. The measure would constrain the growth in initial monthly benefits for future retirees by indexing initial benefits to price growth (rather than wage growth).

H.R. 530 would establish a central authority to administer the accounts and provide at least three initial investment options with specified allocations in equities and fixed income instruments (government bonds, corporate bonds), including a default 60/40 investment mix. Once the account balance reaches $10,000 (indexed to inflation), the worker would be allowed to transfer the balance to a private financial institution. The personal account would become available at retirement, or earlier if the account balance is sufficient to provide an annuity at least equal to 100% of the poverty level. When the account reaches this level, the worker may opt out of Social Security (i.e., no longer pay the employee's share of the payroll tax). The worker would be required to annuitize the portion of the account balance needed to provide an annuity at least equal to 100% of the poverty level. Any remaining balance may be taken as a lump sum. If the balance is not sufficient to provide the prescribed minimum payment, a supplemental payment to the account would be made from general revenues.

Representative Shaw introduced H.R. 750 on February 10, 2005. The measure would allow workers ages 18 and older to participate in voluntary personal accounts funded with general revenues. Account contributions would be equal to 4% of taxable earnings, up to$1,000 (indexed to wage growth).

With respect to traditional Social Security benefits, the measure would provide up to five years of earnings credits for workers who stay at home to care for a child(ren) under age seven and eliminate the earnings test for recipients below the full retirement age. In addition, it would set widow(er)'s benefits equal to 75% of the couple's combined pre-death benefit (compared to 50%-67%); allow widow(er)s to qualify for benefits based on disability

regardless of age and when the disability occurred; and lower the Social Security spousal/widow(er)'s benefit reduction under the Government Pension Offset from two-thirds to one-third of the individual's pension from noncovered employment.

Under H.R. 750, accounts would be administered by private financial institutions selected by the government. The measure would provide three initial investment options with specified allocations in equities and corporate bonds (60/40, 65/35, and 70/30). The personal account would become available upon the worker's entitlement to retirement or disability benefits, or upon the worker's death. Upon entitlement to benefits, the worker would receive a lump sum equal to 5% of the account balance. The remaining balance would be used to finance some or all of the worker's benefit. The account balance would be withdrawn gradually and transferred to the trust funds for the payment of monthly benefits. The measure would guarantee the worker the higher of a current-law promised benefit and an annuity based on 95% of the account balance, plus a lump sum equal to 5% of the account balance.

Senator Hagel introduced S. 540 on March 7, 2005. The measure would allow workers born in 1961 and later to redirect 4 percentage points of the payroll tax to voluntary personal accounts. Workers would be enrolled automatically in the personal account system and given the option to disenroll.

With respect to traditional Social Security benefits, the measure would constrain the growth in initial monthly benefits for future retirees by indexing initial benefits to increases in life expectancy (rather than wage growth). The benefit reduction would not apply to surviving children or surviving spouses with a child in care. While the benefit reduction would not apply to disabled workers below the full retirement age, a pro-rated reduction would apply to disabled workers when they are converted from the disability to the retirement rolls at the full retirement age. In addition, the measure would raise the full retirement age from 67 to 68 for persons born in 1961 and later. It would increase the early retirement reduction factors and delayed retirement credits.

For account participants, the traditional Social Security benefit would be offset by an amount equal to the annuity value of a hypothetical (or "shadow") account assumed to earn a 3% real rate of return.

S. 540 would establish a central authority to administer the accounts and initially provide 5 investment options as under the federal Thrift Savings Plan. The personal account would become available at retirement, or in the event of the worker's death. Upon entitlement to benefits, the worker would be required to annuitize the portion of the account balance needed to provide a combined monthly payment (traditional benefit plus annuity) at least equal to 135% of the poverty level. Any remaining balance could be taken in a manner chosen by the worker.

Legislation

H.R. 440 (Kolbe)

Creates mandatory personal accounts for workers under age 55 financed by redirecting a portion of payroll taxes and makes modifications to Social Security benefits. Introduced February 1, 2005; referred to Committee on Ways and Means and Committee on Rules.

H.R. 530 (Sam Johnson)

Creates voluntary personal accounts for workers under age 55 financed by redirecting a portion of payroll taxes, guarantees participants a payment at least equal to 100% of the poverty line, and makes modifications to traditional Social Security benefits. Introduced February 2, 2005; referred to Committee on Ways and Means.

H.R. 750 (Shaw)

Creates voluntary personal accounts for workers age 18 and older financed with general revenues, guarantees participants a payment at least equal to current-law Social Security benefits, and makes certain benefit improvements. Introduced February 10, 2005; referred to Committee on Ways and Means; Committee on Rules; and Committee on the Budget.

S. 540 (Hagel)

Creates voluntary personal accounts for workers born in 1961 and later financed by redirecting a portion of payroll taxes, makes modifications to Social Security benefits, and raises the full retirement age. Introduced March 7, 2005; referred to Committee on Finance.